payphone locations in order to obtain the best possible commission rate from potential OSPs.[56] This permits them to outbid the LECs, which can offer a commission based only on intraLATA usage.

The result is not fair or balanced competition. It is instead a stacked deck that damages not just the RBOC PSPs but consumers as well. To redress this competitive imbalance and promote public welfare, Congress required in Section 276 that RBOC payphone service providers be given the same right to select and contract with OSPs and IXCs in the same manner that independent PSPs do today. Only if the Commission affirmatively finds that redressing this competitive imbalance would injure the public interest can it disregard Congress's sound judgment to the contrary. No such showing can be made.

Currently, consumers are denied the benefits of true competition in one-stop shopping, since one group of competitors (independent PSPs) can offer it while another group (RBOC PSPs) cannot. Depriving RBOCs of regulatory parity, moreover, would decrease payphone deployment and service quality. Simultaneously deprived of the ability to earn commissions from choosing their OSP and stripped of payphone-supporting subsidies, RBOCs would be forced to remove lower volume payphones throughout their regions and curtail service. This would clearly undermine the purpose of the Act. Moreover, granting RBOCs the right to negotiate with OSPs would give consumers greater protection against gouging, which often occurs in the form of exorbitant end user charges. Because RBOC PSPs have reputations and name-brand recognition

[56]Through the automatic dialing capability of their "smart" telephone equipment, independent payphone operators also can route even intraLATA toll traffic to their chosen interexchange carrier (bypassing the LEC) without requiring the caller to dial extra digits.

to protect, they have a strong incentive to ensure that the customer's payphone interaction is satisfactory in every way -- and not a shock when the bill comes.[57]

Nor would a RBOC PSP's ability to select an IXC raise the specter of discrimination or cross-subsidization from the interLATA market to the payphone market. NPRM ¶ 72. Existing, well-tested safeguards governing transactions between RBOCs and their affiliates provide ample protection against such misconduct. The interexchange service will be bought on the open market from a separate company, making any attempt to cross-subsidize transparent.[58] Moreover, predation is no more feasible here than in enhanced services or wireless services, where Congress has also decided to permit the RBOCs to choose the interexchange carrier and provide a single packaged service.

B. PSPs' Ability to Negotiate With IntraLATA Carriers and Dialing Parity. [NPRM ¶¶ 74-75; 84]

Section 276(b)(1)(E) directs the Commission to grant all PSPs identical rights to select presubscribed intraLATA carriers. The Commission should not, however, mandate the adoption of new technologies to allow intraLATA presubscription at the central office switch. Instead, as the Commission recognizes in its NPRM ¶ 75, it need only announce that the PSPs have the right

[57]As the Commission recognized in its NPRM, independent PSPs and independent LECs compete by reselling 1+ and 0+ service. NPRM ¶ 70. Likewise, the RBOCs should be permitted to provide a single bundled service under their own brand name. This not only will provide them with regulatory parity, but an even stronger incentive to ensure that pricing and quality promote customer loyalty.

[58]Once the RBOCs get in-region interexchange relief, cross-subsidy will still not be a problem. Because interexchange service and payphone service both will be unregulated operations, there is no incentive to cross-subsidize between them. Shifting costs from one side of the ledger to the other has no effect on revenues

to direct intraLATA calls to the carrier of their choice -- thus preempting inconsistent state regulations -- while allowing that mandate to be implemented through existing technology.[59]

The reason for this is straightforward: Independent PSPs can program their "smart" payphone sets to select a presubscribed intraLATA carrier without relying on the local exchange company's central office switch programming. Because independent PSPs have more than adequate means for reaching their carrier of choice, no further changes are needed. Moreover, it is not technically possible for the LECs to reprogram their switches to allow intraLATA presubscription for payphones alone. Consequently, as the Commission recognizes, central-office based presubscription for payphones should be addressed at the same time as all other intraLATA presubscription issues under Section 251 of the Act. See NPRM ¶ 84.

Thus, the Coalition agrees that the benefits of dialing parity adopted pursuant to Section 251(b)(3) of the Act should extend to payphone location providers. But the benefits of dialing parity are exercised not directly but rather through the location providers' choice of PSPs, as the PSP will choose the local exchange carrier, the intraLATA toll, and interLATA access carrier. This is precisely how choices among presubscribed interLATA carriers are made for payphones, and there is no reason to treat the selection of a presubscribed intraLATA carrier any differently.[60]

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[59]TOCSIA already requires presubscribed interLATA carriers to meet minimum standards for the routing and handling of emergency calls. See 47 U.S.C. § 226(d)(3)(A). Many states have adopted the same rules for intraLATA carriers. Accordingly, the Coalition suggests that the Commission need not issue a new rule to that effect. NPRM ¶ 75.

[60]Finally, it is not now technically possible to extend the benefits of payphone dialing parity to individual end-user customers. See Notice of Proposed Rulemaking, Implementation of Local Competition in the Telecommunications Act of 1996, CC Dkt. No. 96-182, at 72, ¶ 207 n.284 (1996) (explaining purpose of dialing parity). Dialing parity is phone-based, not user-based. On payphones, the end user customers are numerous and transient. Although end-users can certainly select their preferred carrier, the technology for instantly adapting the payphone to each new

C. Treatment of Existing Contracts. [NPRM ¶ 73]

Section 276(b)(3) of the Act provides that "nothing in this section shall affect any existing contracts between location providers and payphone service providers or interLATA or intraLATA carriers that are in force and effect as of the date of enactment of the [Telecommunications] Act of 1996." The Coalition agrees with the Commission that this section grandfathers all contracts in existence on or before February 8, 1996, that concern matters otherwise subject to the new requirements or regulations of Section 276. See NPRM ¶ 73 (internal quotation marks omitted). Thus, all such contracts shall remain enforceable, notwithstanding any rules to the contrary, until their earliest expiration date. The statute's protection, however, should only be read to cover contracts enforceable by either party. A location provider's letter of authorization, which merely authorizes the IXC to serve the station, is not enforceable by the IXC and hence should not be grandfathered under the Act. Of course, as explained above, see supra pp.4-5, even where a contract is itself grandfathered, the statute requires that RBOC PSPs be compensated for calls provided under that contract.

V. THE COMMISSION SHOULD ENSURE THAT PUBLIC INTEREST PAYPHONES ARE FINANCED BY THE REQUESTING ENTITY [NPRM ¶¶ 76-82]

In enacting Section 276, Congress recognized that competition in the payphone market would benefit the general public. At the same time, it recognized that so-called public interest payphones required separate consideration. It therefore enacted Section 276(b)(2), which directs the Commission to determine "whether public interest payphones, which are provided in the interest of public health, safety and welfare, in locations where there would otherwise not be a payphone, should be maintained." If the Commission answers that question in the affirmative,

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customers' choice of presubscribed carriers without dialing any extra digits simply does not exist.

Section 276 further instructs the Commission to "ensure that such public interest payphones are supported fairly and equitably."

As an initial matter, the Coalition believes that there is little need for Commission intervention in the public interest payphone market. Local governmental agencies already provide for public interest payphones by making them a part of their contracts with individual payphone service providers. Thus, governmental agencies permit PSPs to place payphones in profitable public locations as long as they also provide payphones in unprofitable locations necessary to public health, safety and welfare. The existence of these arrangements suggest that governmental agencies and PSPs recognize the need to maintain public interest payphones and will do so without federal regulation.

Nonetheless, Section 276(b)(2) imposes three important limitations on public interest payphones that should be reflected in the Commission's definition of a public interest payphone. See NPRM ¶ 80. First, regulators may only require the installation of public interest payphones "in locations where there would otherwise not be a payphone." Section 276(b)(2). Consequently, regulators cannot require the installation of a payphone in a location where a contract for a payphone already exists.

Second, a public interest payphone is by definition one that is "provided in the interest of public health, safety, and welfare." Ibid. Because local governmental agencies bear responsibility for ensuring the "health, safety, and welfare" of the general public, only payphones provided at their request should qualify as "public interest payphones" within the meaning of the Act.

Third, to the extent public interest payphones are required, the Commission must "ensure that such public interest payphones are supported fairly and equitably." Ibid. The best way to do that is also the simplest: require the entity requesting the public interest payphone to pay for it. It would not be "fair[] and equitabl[e]" to require PSPs to provide public interest payphones below cost. Thus, at a minimum, PSPs are entitled to recover their costs plus a reasonable rate of return. There is little reason for the Commission to intervene on pricing, however, because the provision of these phones can be put out to competitive bidding. The PSP providing the most attractive service at the lowest cost will be permitted to install and maintain the phone, for which it will receive recurring compensation.[61]

This approach has several advantages. It "fairly and equitably" compensates PSPs, but at a level designed to reflect the public service aspect of the payphones involved. In addition, it would avoid the administrative burden of other regulatory approaches, such as a requirement that all PSPs share equally among them the responsibility for providing public interest payphones. Although this latter approach might "ensure that such public interest payphones are supported fairly and equitably," it would require a complex analysis of market share or a running tally of the number of public interest payphones each PSP provides.[62]

[61]To deal with existing public interest payphones, the Commission could impose a 60-day notice requirement before those payphones are removed. This 60-day period would give relevant local governmental agencies an opportunity to negotiate for the retention of the phones.

[62]The Commission specifically mentions the California statewide program for designating and funding public interest payphones by means of a fee imposed on all PSPs. NPRM ¶ 79. Although the Coalition does not believe that this model would be appropriate for, or should be imposed on, all the states, the Coalition believes that the Commission should grandfather that particular program in California. Because of the intense payphone competition in California, this particular program fairly and equitably supports public interest payphones. The better solution generally, however -- both as a matter of economics and administration -- is to require the requesting entity itself to pay the market price of public interest payphones. Moreover, in many regions where competition is not so intense and public interest payphones are much more numerous, a tax specific to competitive payphones would be onerous and price these payphones out of the market.

VI. OTHER ISSUES [NPRM ¶¶ 85-88]

A. Semi-Public Payphones.

The Commission does not mention semi-public payphones in its NPRM. But such phones are expressly included in the definition of "payphone service" in Section 276(d), and should be addressed by the Commission.

Semi-public payphones are normally placed in locations where business owners wish to allow customers to make calls (without subjecting the business owners to liability for local and long distance charges), but where call volumes do not justify placing a public telephone. Because they would not be profitable based on end-user usage alone, the location provider pays for them through a tariffed installation charge and subscription rate. Location providers generally request such phones and incur these charges in order to provide customers with access to a phone, to provide the business with a place to receive incoming calls when outgoing calls are limited, and to meet safety needs for the community and travellers.

Although Section 276 does not address semi-public phones separately, it has an important impact on them nonetheless. Semi-public phones will be reclassified as deregulated CPE just like other payphones, and will have to cover their costs, including the cost of the business line to which they are attached.[63] Currently, many states require LEC PSPs to continue to provide semi-public service at a rate that does not cover the costs of installation and service. To ensure that this practice does not continue, the Commission should require that semi-public phones be offered on a deregulated and detariffed basis.[64] If a business wishes to have a semi-public phone placed

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[63]As with any other payphones, PSPs should be able to negotiate with, and select, the carriers serving these payphones.

[64]Again, a 60-day notice period could be required prior to the removal of existing semi-public phones to ensure that location providers have an opportunity to negotiate for their retention.

on its premises, it will have to contract with a PSP. This approach simply reflects the fact that semi-public payphones represent one end of a continuum: PSPs will be willing to pay location providers to install a lucrative station, but the location provider will have to pay to have an otherwise unprofitable payphone installed and maintained on its premises. Business owners who wish to allow customers to make calls at locations where call volume is too low to support a public payphone now have other options. They can purchase regular business access line service with toll restriction, or they can even become independent payphone providers.

B. "Letterless" Keypads.

The Coalition supports the Commission's tentative conclusion to ban letterless payphones. NPRM at ¶ 85. These letters allow consumers to easily dial around or use vanity "800" letters. The Coalition does not believe that there is any justifiable purpose for removing these letters. Indeed, removing these letters has no purpose except to undermine TOCSIA by forcing consumers to use often overpriced OSP services

C. Other Proceedings.

The Coalition agrees with the Commission that it would further the public interest to consolidate the following proceedings into this proceeding:

(1) The Public Telephone Council, DA Dkt. No. 88-2055;

(2) Policies and Rules Concerning Operator Service Access and Pay Telephone Compensation, CC Dkt. No. 91-35;

(3) Petition of Oncor Communications, Inc. Requesting Compensation for Competitive Payphone Premises Owners and Presubscribed Operator Services Providers, DA Dkt. No. 95-1921; and

(4) Amendment of Section 69.2(m) and (ee) of the Commission's Rules to Include Independent Public Payphones Within the "Public Telephone" Exemption from End User Common Line Access Charges, RM Dkt. No. 8723;

In addition, the Commission should consider consolidating the following proceeding with this one as well, ensuring that the rules promulgated here apply to inmate payphones as well:

> In the Matter of the Petition of the Inmate Calling Services Providers Task Force for Declaratory Ruling, RM Dkt. No. 8181

CONCLUSION

The Commission has an opportunity, indeed a mandate, to launch the payphone industry on its way to becoming a fully competitive market. It is critical that each of the decisions in this rulemaking be made with that goal in mind. Competition, not regulation, is the best means of "promot[ing] the widespread deployment of payphone services to the benefit of the general public." 47 U.S.C. § 276(b)(1). Regulation should exist only insofar as necessary to promote the transition to full and fair competition. And the transitional regulations themselves should gradually fade away like the Cheshire cat, leaving behind only the smile of a fully competitive marketplace.

Respectfully submitted,

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July 1, 1996

Andersen Report

ARTHUR ANDERSEN

Calculation of Per-Call Compensation and Review of Accounting and Regulatory Treatment for Payphone Asset Reclassification

Carl R. Geppert

July 1, 1996

Calculation of Per-Call Compensation and Review of Accounting and Regulatory Treatment for Payphone Asset Reclassification

Arthur Andersen LLP ("Arthur Andersen") was asked to perform two studies for the Coalition of Regional Bell Holding Companies, including The Bell Atlantic Companies, BellSouth Corporation, NYNEX Corporation, Pacific Telesis Group, Southwestern Bell Telephone Company and US West, Inc., ("Coalition"). The first entailed computing a per-call compensation ("PCC") for intrastate and interstate calls, as required by Section 276 of the Telecommunications Act of 1996 ("the Act"). The second entailed reviewing the accounting and regulatory treatment for payphone asset reclassifications contemplated in connection with Section 276 of the Act and the Federal Communications Commission's ("FCC") Notice of Proposed Rulemaking ("NPRM") in CC Docket No. 96-128, "Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996," released June 6, 1996. Section I of this report summarizes our findings related to per-call compensation. Section II details our findings related to payphone asset reclassifications.

SECTION I: CALCULATION OF PER-CALL COMPENSATION

The Coalition requested Arthur Andersen to compute per-call compensation based upon two approaches. The methods, each of which will be described in greater detail below, were as follows:

- Market-Based Approach: Compute a range of market values of current commissionable calls to Independent Payphone Providers ("IPPs"). These values represent compensation received by an IPP from an interexchange carrier ("IXCs") and may be viewed as a surrogate for PCC.

- Cost-Based Approach: Compute PCC as the "revenue requirement" per-call (for all call types) necessary to recover the current operating expenses and capital costs of the embedded investment in the payphone business unit. The business unit is assumed to be a distinct unit within the Local Exchange Company ("LEC").

MARKET-BASED APPROACH: PCC BASED UPON CURRENT MARKET VALUE OF IPP COMMISSIONABLE CALLS

We were asked to calculate three amounts that approximate the current market value of IPP commissionable calls. In addition, we were asked to update and revise the 0- transfer service charge study performed in the Second Report and Order. The following matrix provides an overview of the amounts calculated:

Per-Call Commission Received by Largest APCC Member	$0.90
Average Per-Call Compensation Assuming Average AT&T Tariffs	$0.81
Average Non-Coin Per-Call Compensation Received by Three Largest IPP's	$0.84
Updated and Revised 0- Transfer Charge Study	$0.42-$0.49

The following discussion elaborates on how each of the above values were calculated.

A. Per-Call Compensation Received by Largest APCC Member

The first method of computing the existing market rate of commissionable calls entailed gathering information from the American Public Communications Council ("APCC"). The APCC provided the following information:

Average IXC Revenue for Commissionable Call:	$2.50
Largest Member Commission Rate:	36%

Through discussions with the APCC, Peoples Telephone Company, Inc. is currently the overall highest commissioned IPP due primarily to the number of payphones they operate (approximately 40,000). Based upon this information, it is reasonable to assume that any one of the Coalition members, each of which operate in excess of 100,000 payphones, would receive the identical or higher commission rate (i.e., 36% or higher).

Assuming the information provided by the APCC is reliable, the market rate of commissionable calls for an IPP of similar size to any Coalition member is $0.90 (36% x $2.50).

B. Per-Call Compensation Assuming AT&T Tariffed Calls

To independently assess the accuracy of the per-call revenue data provided by the APCC, we performed a second market-based calculation using AT&T tariffs. The three components necessary to perform this calculation were average call durations, tariff charges of 0+/0- calls and call mix.

- Call Duration: We computed the call duration of interlata credit card and collect calls using payphone call data obtained from Coalition members (not all members were able to provide this information). The average call duration was approximately 3.25 minutes.

- AT&T Tariffs: We accumulated the AT&T tariffs through discussions with the FCC. The following matrix provides an overview of the tariff charges (for the average mileage band of 293-430 miles) for calling card and collect calls (a more comprehensive schedule of tariffs is provided in Exhibit A). The average call duration of 3.25 minutes was used to calculate the total call revenue to AT&T

Call Type	Surcharge	Initial Period	Additional Period	Total Revenue
Calling Card Calls:				
Daytime Rates	$0.80	$0.39	$0.34	$1.96
Evening Rates	0.80	0.28	0.23	1.60
Night/Weekend Rates	0.80	0.25	0.20	1.50
Collect Calls:				
Daytime Rates	$2.25	$0.39	$0.34	$3.41
Evening Rates	2.25	0.28	0.23	3.05
Night/Weekend Rates	2.25	0.25	0.20	2.95

- Call Mix: The Second Report and Order suggests calling card calls approximate one-half to three-quarters of all access calls. Using data provided by Coalition members, we narrowed this range to two-thirds (i.e., Coalition data suggest that two-thirds of all 0+/0- calls are credit card calls). In addition, the Second Report and Order provided a breakdown of calling rates (credit card calls: 60% daytime, 24% evening, 16% night/weekend; collect calls: 26% daytime, 44% evening, 30%[1] night/weekend).

[1] The Second Report and Order references 31%. The use of 31% causes the total collect call mix to exceed 100%. The amount was revised to 30% to ensure that the collect call mix totaled 100%.

Using the call duration, tariff and call mix data described above along with the 36% commission rate described in the prior section, we calculated the overall per-call compensation rates as follows:

Call Type	Revenue	Comm (%)	Comm. ($)	Rate Weight	Amount
Calling Card Calls:					
Daytime Rates	$1.96	36%	$0.71	60%	$0.43
Evening Rates	1.60	36%	0.58	24%	0.14
Night/Weekend Rates	1.50	36%	0.54	16%	0.09
				100%	$0.66
		Weight:		67%	$0.44
Collect Calls:					
Daytime Rates	$3.41	36%	$1.23	26%	$0.32
Evening Rates	3.05	36%	1.10	44%	0.48
Night/Weekend Rates	2.95	36%	1.06	30%	$0.32
				100%	$1.12
		Weight:		33%	$0.37
Average Compensation					$0.81

C. Per-Call Compensation of Largest IPPs

The third estimate of the market value of a commissionable call entailed analyzing specific IPPs. Using publicly available payphone and compensation statistics, we analyzed the 1995 performance of the three largest IPPs (Peoples Telephone Company, Inc., Davel Communications Group, Inc. and Communications Central, Inc.). Combined, these IPPs represent approximately 25% of the IPP payphone market.

The value of commissionable calls to these IPPs is evident in the compensation received by Peoples, Davel and CCI for non-coin calls. We accumulated both the total number of payphones and the total non-coin compensation received by the three companies for the year 1995. The non-coin revenue ($124 million) was divided by the total number of payphones (75,102) to arrive at an average of $1,647 non-coin compensation per station per year.

To convert the per-station non-coin compensation to a per-call amount, we calculated the average number of non-coin telephone calls per station per year (local NSP, intralata NSP, interlata NSP and dial around) from the available Coalition data. The average number of non-coin calls per station per year was 1,953.

Using the average non-coin compensation per station and the average non-coin calls per stations, we calculated the compensation per-non-coin call by dividing the average non-coin compensation per station per year by the average non-coin calls per station per year. This produced an average compensation per-non-coin call of $0.84, computed as follows (see Exhibit B for additional detail on the non-coin compensation calculation):

Non-Coin Compensation Per Pay Station:	$1,647
Non-Coin Calls Per Pay Station:	1,953
Non-Coin Compensation Per Call:	$0.84

It must be noted that the $0.84, if used as an estimate for compensation on pre-subscribed calls only, is artificially low. This is due primarily to the fact that the non-coin revenue figures used in this calculation include below-market amounts received for carrying non-pre-subscribed calls (e.g., $0.25 per call). Were the non-coin compensation for these type of calls and their related call counts excluded, the amount would increase.

D. Revised 0- Transfer Charge Analysis

In its' Second Report and Order, the FCC used 0- transfer service charges as a reasonable basis for computing PCC. The Coalition requested that Arthur Andersen update this study to a) reflect current 0- transfer service charges; and b) revise the methodology followed in the Second Report and Order by converting the 0- transfer service charge to a "completed call" amount rather than an "attempted call" amount. The purpose of the latter exercise is to more accurately represent what operator service providers pay, on a regulated basis, to obtain a completed call rather than an attempted call (i.e., operator service providers currently pay compensation on completed calls, not attempted calls).

The updated range of 0- transfer charges for the entities cited in the Second Report and Order is $0.22 to $0.46. The simple average of these two figures is $0.34. With regard to call completion statistics, we were informed of completion studies performed by Bell Communications Research and one Coalition member. The resultant range of completion ratios was approximately 69% to 81%. Based upon the updated 0- transfer charges and the range of completion ratios provided in the above mentioned studies, the updated/revised 0- transfer charge for "completed" calls ranges from $0.42 - $0.49

COST-BASED APPROACH: PCC BASED UPON EMBEDDED DIRECT COSTING

We have also calculated PCC based upon the direct costs of the new public payphone operating unit plus a reasonable level of return on the fully embedded asset base. As discussed in Section II of this report, Section 276 of the Act requires the Coalition members to establish, at a minimum, a Computer Inquiry III non-structurally separate business unit to run the payphone operations. This business unit will separately track all direct expenses as well as support related expenses provided by corporate operations. The business unit will also separately track the fully embedded asset base of payphones and enclosures. In general, the payphone business unit will have its own income statement.

A. Per-Call Compensation Based Upon Overall Business Unit Costs

To calculate PCC based upon the costs of the payphone business unit plus a reasonable return on the fully embedded asset base, we first specified the costing methods to be used in developing the cost basis for the PCC and distributed this methodology to the Coalition members. Each Coalition member responded by providing payphone recurring revenues, payphone costs, payphone tariffs, payphone call quantities and payphone station quantities for the year ended December 31, 1995 or their best estimate for the year ended December 31, 1995.

Using the data provided by the Coalition members, we developed an electronic spreadsheet model to compute per-call costs for payphone services ("per call cost model"). In general, the model is structured as follows:

Recurring Revenues:
Semi-Public Revenues
Booth Revenues

Less Costs:
Volume Sensitive Costs
- Local Usage

Station Sensitive Costs
- Subscriber Line Charge
- Coin Access Line Charge
- Collections and Counting
- Station Equipment (including return on embedded base)

Joint Costs
- Forecasting and Budgeting
- Product Management
- Marketing and Sales
- Business Office
- Advertising

Common Costs
- Real Estate
- Finance
- Legal
- Other Corporate

Commissions

The net impact of recurring revenue less business unit costs (including a reasonable return on the fully embedded asset base) is the amount of revenue necessary for the business unit to generate through per-call compensation.

After entering the Coalition data into the per-call cost model, we performed certain inquiries with respect to the completeness of the data. After receiving any corrections, we computed the average annual embedded direct cost per paystation for the year ended December 31, 1995 for the Coalition as a whole and for each member of the Coalition. The average annual embedded direct cost per paystation for the year ended December 31, 1995 for the Coalition as a whole was $1,744 per year. The per-paystation costs for each Coalition member ranged from a low of $1,310 to a high of $2,102 per year.

Next, we computed the average per-call cost for the year ended December 31, 1995 for the Coalition as a whole and for each member of the Coalition by dividing the cost per paystation by the average annual call volumes per paystation. The average per-call cost for the year ending December 31, 1995 for the Coalition as a whole was $0.29. The average per-call costs for each Coalition member ranged from a low of $0.25 to a high of $0.32.

B. Per-Call Compensation Including Local Sent Paid Revenue

The Coalition also requested that we compute the PCC of all non-local sent paid calls assuming that existing local sent paid rates remain in effect. This analysis demonstrates that when local calling rates are maintained at a level below costs, the resulting PCC on all non-local sent paid calls must increase.

Currently, a small number of states have local calling rates of $0.10 with the majority of states having a $0.25 local charge. In several states, the local calling rate has been increased to $0.35. Historically, Bell Operating Companies ("BOCs") have received a subsidy to compensate them for the low local calling rates. Section 276 of the Act now prohibits cross subsidization and requires BOCs to be fairly compensated for each and every intrastate and interstate call.

To compute the PCC assuming local rates remain in place, we used the fully embedded cost model described above but included 1995 local sent paid revenue at current rates. The difference between the fully embedded costs (including a reasonable rate of return) and the business unit revenues (including local sent paid, semi-public and other booth revenues) was divided by all calls excluding local sent paid. The overall Coalition average PCC using this methodology was $0.43. This amount varied by Coalition member from a high of $0.73 to a low of $0.22.

SECTION II: ACCOUNTING AND REGULATORY TREATMENT FOR PAYPHONE ASSET RECLASSIFICATION

Arthur Andersen was also asked to analyze the accounting and regulatory treatment for payphone asset reclassifications contemplated in connection with provision Section 276 of the Act and the NPRM. This section of our report includes the following topics of discussion:

- The general payphone service requirements of Section 276 of the Act related to nonstructural safeguards.
- Our opinion on the adequacy of nonstructural cost accounting safeguards to prevent cross subsidization of payphone service with regulated telecommunications service.
- Accounting for past asset reclassifications under the applicable FCC orders.
- Accounting for asset reclassifications under Generally Accepted Accounting Principles ("GAAP").
- Our opinion on appropriate accounting for payphone service asset reclassifications.

THE GENERAL PAYPHONE SERVICE REQUIREMENTS OF SECTION 276 OF THE ACT RELATED TO NONSTRUCTURAL SAFEGUARDS

The provisions of the Act, Section 276 (b) (1) (C) "prescribe a set of nonstructural safeguards for BOC payphone service to implement the provisions of paragraphs (1) and (2) of subsection (a), which safeguards shall at a minimum, include the nonstructural safeguards equal to those adopted in the Computer Inquiry-III (CC Docket No. 90-623)".

Structural separation safeguards require establishing a separate subsidiary to provide nonregulated services. Separate subsidiary arrangements were initially required in 1980 for AT&T Corp. and the BOCs to prevent cross-subsidization between the carriers' regulated and nonregulated operations. The Computer Inquiry III Proceedings ("CI-III") removed the structural separation requirements from AT&T and the BOCs for the provision of enhanced services and established nonstructural safeguards. The nonstructural safeguards include cost allocation rules that provide a mechanism for separating the costs of regulated and nonregulated activities without using separate subsidiaries.

The next section of this report reflects our opinion on the adequacy of nonstructural cost accounting safeguards in general and the remainder of this report will address the basis under which payphone assets should be reclassified to separate nonregulated activities.

OUR OPINION ON THE ADEQUACY OF NONSTRUCTURAL COST ACCOUNTING SAFEGUARDS TO PREVENT CROSS SUBSIDIZATION OF PAYPHONE SERVICE WITH REGULATED TELECOMMUNICATIONS SERVICE

The FCC's cost accounting safeguards, as reflected in the Computer Inquiry III Remand Proceedings (CC Docket No. 90-623)[2], contain no loopholes that could result in a regulated service subsidizing nonregulated activity, in this case payphone service. The combined joint cost allocation and affiliate transaction rules protect customers of regulated services from cross-subsidization regardless of how a BOC offers nonregulated services. Furthermore, the FCC appeared to fully appreciate that its joint cost allocation rules assign more costs to nonregulated activities than required to prevent cross-subsidy.[3] If a BOC offers nonregulated services directly, the Part 64 joint cost allocation rules ensure that the costs of such nonregulated activities are properly separated from the costs of regulated services. Alternatively, if the BOC offers the same services through a nonregulated affiliate, the affiliate transaction rules again protect the BOC's ratepayers from indirect cross-subsidization that could occur through improper transactions between the two affiliates.

In addition to the above cost allocation and affiliate transaction accounting requirements, existing FCC safeguards include a broad spectrum of rules, audits and

[2] Computer III Remand Proceedings; Bell Operating Company Safeguards and Tier 1 Local Exchange Company Safeguards, 6 FCC Rcd 7571, (1991). [hereinafter "BOC Safeguard Order"].
[3] Separation of Costs of Regulated Telephone Service for Costs on Nonregulated Activities., 2 FCC Rcd 1298 (1987) at 1313. [hereinafter "Joint Cost Order"]

reporting requirements which effectively control the LECs' provision of regulated and nonregulated services. These safeguards include but are not limited to, the following.

1. Accounting rules and cost allocation standards which include FCC provisions that assure a service contributes to general overhead costs which would otherwise be borne solely by the regulated ratepayer.[4]
2. Cost allocation manual ("CAM") uniformity aimed at facilitating FCC review of LEC CAMs to ensure that they are consistent in their application of the joint cost allocation rules.[5]
3. Requirement to file updated CAMs reflecting the established rules and current affiliate and nonregulated transactions.[6]
4. External audits, which include affiliate transactions in their scope, that:
   a) provide the same level of assurance with respect to the joint cost allocation results reported to the FCC as that provided on a financial statement audit engagement;[7]
   b) render an opinion on whether the carriers' cost allocation methodologies comply with the CAM and the FCC's joint cost allocation rules;[8]

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[4]See, 47 C.F.R. § 32.27 (1995); 47 C.F.R. § 64.901 (1995); 47 C.F.R. § 64.902 (1995).
[5] See, Implementation of Further Cost Allocation Manual Uniformity, AAD 92-42, Order Inviting Comments (Released October 13, 1992); Memorandum Opinion and Order (Released July 1, 1993).
[6] 47 C.F.R. § 64.903 (1995); BOC Safeguard Order, supra note 2, at 7591.
[7] BOC Safeguards Order, supra note 2, at 7582.
[8] Id, at 7582.